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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966

No. 893

SNYDER BROTHERS COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Snyder Brothers Company prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case on July 26, 1966.

CITATIONS TO OPINIONS BELOW

The United States District Court for the Northern District of Georgia, Gainesville Division, issued no opinion. The opinion of the Circuit Court of Appeals, printed in Appendix A hereto, *infra*, p. A1, is reported in 66-2 U.

S.T.C. ¶ 9573 and 18 A.F.T.R.2d 5316. The opinion of the Circuit Court of Appeals denying rehearing printed in Appendix A hereto, *infra*, p. A24, is reported in 18 A.F.T.R. 2d 5707. The official reports of these opinions have not yet appeared.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 26, 1966 (R. 117); Appendix A, *infra*, p. A23. Petition for rehearing and for rehearing *en banc* was timely filed on August 16, 1966. (R. 118.) Rehearing was denied on September 27, 1966 (R. 141); Appendix A, *infra*, p. A24. Mandate was issued on October 5, 1966. (R. 117); Appendix A, *infra*, p. A23. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1)

QUESTION PRESENTED

Whether the debentures issued by petitioner, which state an unconditional and legally enforceable obligation to pay principal and interest on fixed dates, and which the Government admits were intended to create bona fide debt, fail to qualify as "indebtedness" under § 163(a) of the Internal Revenue Code of 1954, *as a matter of law*, solely because they were initially issued to stockholders and are subordinated.

STATUTE INVOLVED

The statutory provision involved is § 163(a) of the Internal Revenue Code of 1954, which provides:

> "(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

STATEMENT

From April 1, 1947 until November 30, 1957, two brothers, Franklin D. Snyder and Floyd R. Snyder, carried on the business of manufacturing industrial furniture finishes as a partnership operating under the name of Snyder Brothers Company. (R. 83.) This partnership was highly successful, having average annual earnings for 1955 through 1957 in excess of $87,000. (R. 84.)

On November 30, 1957 the two brothers transferred substantially all of the assets of their partnership to petitioner, a new Georgia corporation which they had organized with the name of Snyder Brothers Company [hereinafter petitioner is referred to as the "Company"]. In exchange for partnership assets having a book value of $450,382.87, the Company assumed the liabilities of the partnership in the amount of $202,568.13 and issued to the brothers capital stock of the Company having a par value of $100,000. It also issued to the brothers "6% Subordinated Debentures" [hereinafter referred to as the "debentures"] in the principal amount of $140,000. The book value of the assets transferred to the Company exceeded by $7,814.74 the sum of the liabilities assumed, the par value of the stock issued, and the stated principal amount of the debentures. This amount was carried on the Company's books as "paid-in surplus." Having been equal partners in the transferring partnership, each brother received one-half of the capital stock and one-half of the debentures. (R. 83.) The Company's ratio of debt to equity was approximately 1.3 to 1.

The debentures[1] constituted the absolute, fixed and unconditional obligation of the Company to pay interest semi-

1. A sample debenture is printed as an appendix to the opinion of the Court of Appeals for the Fifth Circuit [hereinafter cited as "Opinion"], R. 105, set forth herein in Appendix A, *infra*, p. A13.

annually at six per cent per annum and to repay principal on December 1, 1977, twenty years later. They were subordinated to the present indebtedness of the Company and to all future indebtedness not specifically subordinated. They contained no restrictions on transfer. Debenture holders were given no voting rights whatsoever with respect to the Company.

The debentures have at all times been treated as indebtedness on the books of the Company, with the semiannual payments shown as interest, and all such payments have been made promptly when due. (R. 83.) Further, the intent of the parties to create valid indebtedness is not disputed.[2]

The Company sought to deduct the semiannual payments as interest for federal income tax purposes, but the Commissioner of Internal Revenue disallowed the deductions on the ground that the debentures were equity investments, rather than indebtedness, with the result that the semiannual payments constituted dividends and not interest within the meaning of § 163(a) of the Internal Revenue Code of 1954. The Company paid the assessed deficiency and instituted suit for refund, invoking the jurisdiction of the United States District Court under 28 U.S.C. §§1340 and 1346 (a)(1). (R. 4-7, 12-14.)

At the trial the Company introduced a stipulation of facts,[3] a sample debenture, its corporate minute and stock

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2. According to the Government:

"[I]n the instant case *the intent of the parties is not at issue.* . . Whether the 'Debentures' constituted a capital investment depends not on a determination of anyone's intent but rather on a characterization of the instrument here involved." (Emphasis added).

Reply Brief for the Appellant at 10, quoted in footnote 1 of the dissenting opinion, R. 110, Appendix A, *infra*, p. A17.

3. The stipulation of facts is set forth in the Record at 82-85.

books, its federal income tax returns and audit reports for the years in question, and the final federal income tax return of the partnership. (R. 21-40.) Following introduction of this documentary evidence, and without oral testimony, the Company rested. The United States [hereinafter referred to as the "Government"] then moved for a directed verdict, which the court denied (R. 42 & 50), and the Government rested without introducing any evidence whatsoever. (R. 50.) The Company then made a motion for a directed verdict which the court granted (R. 54-57), and judgment was entered for the taxpayer. (R. 62, 63.) The Government subsequently filed a motion for judgment notwithstanding the verdict, and, in the alternative, for a new trial. (R. 64-69.) This motion was denied. (R. 70-73.)

The Government appealed the decision of the District Court to the United States Court of Appeals for the Fifth Circuit. (R. 74.) The Fifth Circuit majority, over Judge Gewin's vigorous dissent, reversed the trial court not for a new trial but for entry of judgment in favor of the Government. (R. 104.) According to the majority, "the issue here to be decided is one of law"[4] (R. 94.), depending "solely upon our construction of the instrument."[5] (R. 92.) Moreover, the court summarized, citing *Gregory* v. *Helvering*[6], that:

> "The net of the matter is that for us to construe this document under these circumstances as 'an indebtedness' would be to give substance to a 'transaction [which] upon its face lies outside the plain intent of the statute.' "[7] (R. 103-104.)

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4. Opinion, Appendix A, *infra*, p. A4.
5. Opinion, Appendix A, *infra*, p. A2.
6. 293 U.S. 465, 470 (1935).
7. Opinion, Appendix A, *infra*, p. A12.

Upon entry of judgment for the Government (R. 117), the Company made a timely petition for rehearing and for rehearing before the court *en banc*. (R. 118.) With Judge Gewin again dissenting, the Circuit Court denied the Company's motion with a brief opinion, which concluded:

> "As a matter of law, the debentures here in question do not create a 'debt' within the contemplation of the applicable statute."[8] (R. 141.)

REASONS FOR GRANTING WRIT

1. The decision of the United States Court of Appeals for the Fifth Circuit below is in conflict with the decision of the Supreme Court in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946), the only decision of this Court with respect to the question presented by this case. In *John Kelley Co.* the taxpayer issued to its stockholders 20-year debentures, subordinated to all other creditors, with interest payable only if and to the extent earned each year, not cumulative. The Supreme Court reversed the Court of Appeals for the Seventh Circuit and affirmed the Tax Court's decision that interest paid on the debentures was deductible.

Under the rule laid down in the present case by the court below, the deduction of interest on the debentures in *John Kelley Co.* would have been disallowed as a matter of law.

The Fifth Circuit majority dismissed *John Kelley Co.* v. *Commissioner* with the statement that "this case has no precedential value beyond that of any other decision of the Tax Court,"[9] because it was based on the *Dobson* rule.[10]

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8. Opinion of the Court of Appeals for the Fifth Circuit denying rehearing [hereinafter cited as "Opinion denying rehearing"], R. 140, set forth herein in Appendix A, *infra*, p. A24.

9. Opinion, Appendix A, *infra*, p. A9.

10. *Dobson* v. *Commissioner*, 320 U.S. 489 (1943).

In taking this position, however, the Fifth Circuit has construed too narrowly the import of *John Kelley Co.* If this Court had considered that the characteristics of the debentures in *John Kelley Co.*, coupled with stockholder ownership, placed such debentures "outside the plain intent of the statute," as a matter of law, it could and would have said so, notwithstanding the *Dobson* rule. The characteristics of the securities under consideration in *John Kelley Co.* placed them much closer to "preferred stock" than do the characteristics of the debentures in the instant case. Nevertheless, this Court in *John Kelley Co.* expressly rejected the idea that the status of such securities under the income tax law could be determined as a matter of law.[11] The fact that this Court's decision in *John Kelley Co.* was based on the *Dobson* rule points up the conflict between that decision and the present one, rather than preventing conflict.

2. If the lower court should be correct in dismissing *John Kelley Co.* v. *Commissioner* as having "no precedential value beyond that of any other decision of the Tax Court," then that premise is a compelling reason for this Court to grant certiorari—for there is no other Supreme Court decision on the important question of what constitutes corporate indebtedness under § 163(a). As is generally recognized, there is probably more confusion with respect to this question than with respect to any other point of federal tax law. The conflict of circuit court decisions, discussed hereinafter, combined with the superabundance of lower court decisions,[12] and articles by respected commentators,[13]

11. 326 U.S. at 527.

12. Some of the most recent decisions which have struggled with the problem of whether nominal debt constitutes indebtedness within the meaning of § 163(a) are: *Affiliated Research, Inc.* v. *United States*, 351 F.2d 646 (Ct. Cl. 1965); *Doornbosch Bros.*, 46 T.C. No. 17 (1966); *W. C. Gamman*, 46 T.C. 1 (1966);

demonstrate the uncertainty of this area. The Treasury has done nothing to lessen the confusion, either among taxpayers or among its own agents. It has published absolutely no Regulations on the subject. It has issued no published rulings and has stated that it will not issue any private rulings on the question.[14] Moreover, notwithstanding taxpayer's confidence that *John Kelley Co.* is a precedent of current vitality, at least with respect to the question presented by the instant case, it must be admitted that this

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Irbco Corp., 25 T.C.M. 359 (1966); *Jack Daniel Distillery*, 667 CCH Fed. Tax Rep. ¶ 8154 (Ct. Cl. Comm'r Rep. 1966); *John Town, Inc.*, 46 T.C. 107 (1966); *Obermeyer* v. *United States*, 66-2 U.S.T.C. ¶ 9728 (S.D. Ohio 1966); *Old Dominion Plywood Corp.*, 25 T.C.M. 678 (1966); *A. L. Stanchfield*, 24 T.C.M. 1681 (1965); *Stone Mountain Grit Co.*, 65-2 U.S.T.C. ¶ 9702 (N.D. Ga. 1965); *Wood Preserving Corp.*, 347 F.2d 117 (4th Cir. 1965); *Wynnefield Heights, Inc.*, 25 T.C.M. 953 (1966).

13. The following articles constitute a sampling of the flood of periodical literature in which the commentators attempt to find guidelines in this area: Aarons, *Debt v. Equity: Special Hazards in Setting Up the Corporate Capital Structure*, 23 J. Taxation 194-97 (Oct. 1965); Bittker, *Thin Capitalization: Some Current Questions*, 34 Taxes 830 (Dec. 1956); Caplin, *The Caloric Count of a Thin Incorporation*, 17th Ann. N.Y.U. Tax Inst. 771 (1959); Dixon, *The Interest-Dividend Syndrome: What Are the Criteria Now?* 24th Ann. N.Y.U. Tax Inst. 1267-90 (1966); Farrar, *Is Interest Deductible Only If the Debt Has a Nontax Profit Purpose*, 13 J. Taxation 258 (Nov. 1960); Gerver, *De-Emphasis of Debt-Equity Test for Thin Corporations Requires New Defense Tactics*, 23 J. Taxation 28-31 (July 1965); Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 Tax. L. Rev. 1 (Nov. 1960); Hellerstein, *Tax Court Approach to Thin Incorporation Defended*, 10 J. Taxation 88 (Feb. 1959); Hertz, *Getting Property Into and Out of the Corporation*, 21st Ann. N.Y.U. Tax Inst. 347 (1963); Lewis, *110,000 to Zero Debt-Equity Ratio No Bar to Finding Debtor-Creditor Relationship Between Corporation and Stockholder*, 15 Syracuse L. Rev. 118-122 (Fall 1963); Morris, *Intent Test Grows As Determinant on Thin Incorporation Safety; Recent Cases Guide*, 13 J. Taxation 130 (Sept. 1960); Weirs, *The Labyrinth of the Thin Corporation*, 40 Taxes 568 (Jul. 1962); Weyber & Weithorn, *Capital Structure of New Corporations*, 16th Ann. N.Y.U. Tax Inst. 277 (1958); *New Thin Incorporation Threat: Repayment of Guaranteed Bank Loans Treated As Dividends*, 23 J. Taxation 197-99 (Oct. 1965).

14. Rev. Proc. 64-31, 1964-2 C.B. 947.

Court's use of the *Dobson* rule in *John Kelley Co.* makes it difficult for taxpayers, the lower courts and the Commissioner to use it as a guide. Thus, whether or not the lower court is correct regarding *John Kelley Co.*, its comment does point up the great need for clarification in an area so confusing as to conflict with the guaranty inherent in the American system of law that a citizen be reasonably apprised, in advance, of the consequences of his acts. For this reason, this Court should grant certiorari to examine and clarify this important question of federal tax law.

3. The Fifth Circuit is also in conflict with *John Kelley Co.* v. *Commissioner, supra,* when it bases the decision in the instant case on the rationale of *Gregory* v. *Helvering,* 293 U.S. 465 (1935). The reasoning of the court below apparently is that even though an instrument is regular in form and constitutes valid indebtedness for commercial purposes, *and even though the intent of the parties to create a valid indebtedness is unquestioned,* some doctrine stemming from *Gregory* v. *Helvering* may prevent it from being recognized as indebtedness for tax purposes.[15] Whatever else may be said about the decision of this Court in *John Kelley Co.* v. *Commissioner,* it certainly rejected the application of *Gregory* v. *Helvering* to the determination of whether debentures having all the features of the debentures in this case constituted indebtedness for tax purposes. This Court there said:

> "There is not present in either situation [the situation of either of the debentures involved in this case] the wholly useless temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering,* 293 U.S. 465. The demonstrated possibility of sales by the holders

15. See Opinion, Appendix A, *infra,* p. A6.

of the obligations to persons other than stockholders alone proves the differentiation."[16]

Thus the majority opinion below, in relying on the rationale of *Gregory* v. *Helvering*, is clearly contrary to the views of this Court in its only applicable decision.

4. The decision of the majority in the Court of Appeals for the Fifth Circuit places that court in clear and irreconcilable conflict with the well-established rule in the Second Circuit that subordinated indebtedness owed to stockholders does not, as a matter of law, fail to qualify as indebtedness for tax purposes. *Commissioner* v. *O.P.P. Holding Corp.*, 76 F.2d 11 (2d Cir. 1935), *affirming* 30 B.T.A. 337 (1934); *Commissioner* v. *Page Oil Co.*, 129 F.2d 748 (2d Cir. 1942); *Kraft Foods Co.* v. *Commissioner*, 232 F.2d 118, 125-26 (2d Cir. 1956). Moreover, this decision is also in clear conflict with the announced position of the Commissioner of Internal Revenue. See the Commissioner's acquiescences in *O.P.P. Holding Corp.*, *supra*, acq. 1959-1 C.B. 6, and in *Clyde Bacon, Inc.*, 4 T.C. 1107 (1945), acq. 1945 C.B. 1.

The leading decision of the Second Circuit is *Commissioner* v. *O.P.P. Holding Corp.*, *supra*, in which that court allowed the interest deduction despite facts which were far more favorable to the Government than in the instant case.[17] In *O.P.P. Holding Corp.*, the stockholders of an existing corporation transferred all their stock to a new corporation in exchange for *all* of the stock, having a stated value of $10,000, plus *all* of the debenture bonds, in the amount of $250,000, of the new corporation. The debentures were subordinated to the claims of all other

16. *John Kelley Co.* v. *Commissioner*, *supra* at 525.

17. For convenience, the opinion of the Court of Appeals for the Second Circuit in *Commissioner* v. *O.P.P. Holding Corp.* is printed as Appendix B, *infra*, p. A26.

creditors, and the issuing corporation at its option could suspend or defer the payment of interest until final maturity. The debentures were for a term of 25 years. The Board of Tax Appeals held that the debentures constituted indebtedness[18] and the Second Circuit Court of Appeals affirmed, saying:

> "We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment. The shareholder is entitled to nothing, prior to liquidation, except out of earnings. . . . These debenture bondholders were not so limited. . . . This distinction marks the vital difference between the shareholder and the creditor."[19]

The majority opinion attempts to distinguish *O.P.P. Holding Corp.* solely on the "very significant circumstance" that there the issuing corporation "obligated itself to pay no dividends to its stockholders as long as any interest payments on the debenture bonds remained unpaid."[20] The majority fails to mention, however, that this obligation was coupled with a provision permitting the corporation at its option to defer payment of any interest on the debentures until the final maturity, twenty-five years from date of issue.[21] In the instant case the Company has no right to defer interest. It is unconditionally obligated to pay interest semiannually. Having no option to defer

18. 30 B.T.A. 337, 341 (1934).

19. *Commissioner* v. *O.P.P. Holding Corp.*, *supra* at 12, Appendix B, *infra*, p. A28.

20. Opinion, Appendix A, *infra*, p. A8.

21. *Commissioner* v. *O.P.P. Holding Corp.*, *supra* at 12, Appendix B, *infra*, p. A28.

interest, a provision that the Company could not pay dividends while deferring interest would be meaningless, since, as a matter of law, the corporation could not pay dividends while in default in the payment of interest.[22]

The most recent statement of the position of the Second Circuit is in *Kraft Food Co.* v. *Commissioner*, 232 F.2d 118 (2d Cir. 1956). There a subsidiary corporation issued to its parent a dividend of debentures in the amount of $30,000,000, with the admitted primary motivation of obtaining a tax benefit. In answer to the Commissioner's contention that the debentures were subordinated to general creditors and therefore not indebtedness, the Second Circuit stated:

> "Subordination to general creditors is not necessarily indicative of a stock interest. Debt is still debt despite subordination."[23]

For this proposition the Second Circuit relied upon *John Kelley Co., supra*, as well as its prior decisions in *O.P.P. Holding Corp.* and *Commissioner* v. *Page Oil Co., supra.*

The Commissioner of Internal Revenue originally announced a nonacquiescence in the decision of the Board of Tax Appeals in *O.P.P. Holding Corp.* XIII-2 C.B. 27 (1934). Subsequently, however, this nonacquiescence was withdrawn and an acquiescence was substituted. 1959-1 C.B. 5. The fact that the Commissioner in 1959 withdrew the previous nonacquiescence, after the lapse of 25 years, and announced his acquiescence is significant. It demonstrates that the acquiescence was the result of a studied policy decision by the Commissioner and was not merely a routine acquiescence. Moreover, it further demonstrates that the decision of the Second Circuit in *O.P.P. Holding Corp.* has

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22. See 11 Fletcher, *Corporations*, § 5324 (1958 rev.).

23. *Kraft Food Co.* v. *Commissioner, supra* at 125-26.

increased rather than diminished in significance with the passage of time.

The conflict between the instant decision and the decisions in the Second Circuit is direct, and the cases cannot be reconciled. The Second Circuit cases clearly hold that the fact that stockholder-owned debentures are subordinated to general creditors is not "fatal to the debenture holder's status as a creditor."[24] On the other hand, the Fifth Circuit majority holds that the combination of stockholder ownership and subordination to all other creditors places debentures "outside the plain intent of the statute," as a matter of law.

The direct conflict between the instant decision and the decisions of the Second Circuit is not lessened by the fact that the majority opinion points to other "characteristics" of the debentures which are said to have influenced the decision.[25] The strong implication is that these characteristics are unique and set the Snyder debentures apart from the usual form of subordinated debentures. This, however, is not the case. These characteristics are common in cases involving subordinated debentures owned by stockholders. For example, all four of the characteristics listed were present in *John Kelley Co.* v. *Commissioner, supra.* In *Kraft Food Co.* v. *Commissioner, supra,* all were present, except that the term was fifteen years instead of twenty. In *Commissioner* v. *Page Oil Co., supra,* the notes involved were payable on demand after five years, but each of the other characteristics were present. In *O.P.P. Holding Corp.* there was a limitation on dividends while interest was deferred, as discussed above. Otherwise, all the characteristics were present. In *Clyde Bacon, Inc.,* 4 T.C. 1107

24. *Commissioner* v. *O.P.P. Holding Corp., supra* at 12, Appendix B, *infra,* p. A28.

25. Opinion, Appendix A, *infra,* p. A8.

(1945), acq. 1945 C.B. 1, all four characteristics were present. The fact is that the "other characteristics" of the debentures mentioned by the majority opinion are characteristic of and will be present in virtually all subordinated indebtedness. As a practical matter, the reference to them merely obscures from the casual reader that the court has held that subordinated indebtedness issued to stockholders is not valid for tax purposes.

Another feature of the majority opinion which might obscure the revolutionary character of this decision is the treatment of *Rowan* v. *United States*, 219 F.2d 51 (5th Cir. 1955), where stockholder advances to an insolvent corporation were upheld as indebtedness. The court first indicates that the question in the instant case is not the same as in *Rowan*, where the issue was the intent of the parties.[26] Later, however, the court compares the two cases for the purpose of pointing out that "a number of things are present in the case before us that we specifically noted were not present in the *Rowan* case."[27] The facts and circumstances used for the comparison between *Rowan* and this case are admittedly significant where the issue for determination is whether the parties intended to create a bona fide indebtedness. The court below repeatedly states, however, that this is not the issue here. Such facts are not significant to a determination of whether these debentures issued to stockholders failed to qualify as indebtedness as a matter of law. If they did fail to qualify as a matter of law, then the question of intent present in *Rowan* is never reached. If they did not fail to qualify as indebtedness as a matter of law, then the facts and circumstances that bear on intent would become relevant, except that the Government in the instant case has conceded the issue of intent.

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26. Opinion, Appendix A, *infra*, p. A6.
27. Opinion, Appendix A, *infra*, p. A11.

Stripped of its dictum and irrelevant discussion, the holding of the decision below can only be that subordinated debt issued to stockholders does not, as a matter of law, constitute indebtedness within the meaning of § 163(a) of the Internal Revenue Code. The Fifth Circuit cites no authority in support of this holding, and to our knowledge none exists. Such holding conflicts with the several decisions of the Second Circuit, discussed above. This Court should grant certiorari to consider this revolutionary departure from established precedent and to dispel the uncertainty which will result from the decision of the Fifth Circuit in this case.

5. The question presented by the instant case is of great importance to many taxpayers and to the general business community. In reliance upon *John Kelley Co.* v. *Commissioner*, the decisions of the Second Circuit discussed above, and the announced policy of the Commissioner, many taxpayers who are stockholders of corporations have made investments in subordinated debentures of such corporations. As indicated by Judge Gewin in his dissent below, "subordination is not condemned but is an approved business practice."[28] It has grown in usage and importance in recent years.[29] This is particularly true in the case of closely held corporations, for it is customary for banks and lending institutions to require stockholders of such corporations to subordinate any stockholder-owned indebtedness.

Heretofore it has been recognized that subordination of stockholder-owned debt was a relevant factor in the determination of whether such debt constituted "indebted-

28. Opinion, Appendix A, *infra*, p. A20.

29. See, *e.g.*, Everett, *Subordinated Debt—Nature and Enforcement*, 20 Bus. Law. 953 (1965); Johnson, *Subordinated Debentures: Debt That Serves As Equity*, 10 J. Finance 1, 4-9 (1955); Golin, *Debt Subordination As a Working Tool*, 7 N.Y. Law Forum 370 (1961).

ness" for tax purposes. This determination, however, has been viewed as a question of fact, turning on the intent of the parties as gleaned from all the facts and circumstances.[30] No court has previously held that subordinated debt owned by stockholders cannot qualify as "indebtedness" for tax purposes, as a matter of law, even though it is admitted that the parties intended to create bona fide indebtedness. The Government and the court below both disavow that this case turns on the intent of the parties and agree that the only question involved is whether the debentures *on their face* constitute indebtedness when issued to stockholders.[31]

The direct result of the decision below to the Company and the holders of its debentures is to deny to the Company the deduction for interest paid on the debentures. The ultimate result, however, both to the taxpayers here and to many other taxpayers, is much more drastic. When debt instruments are held to constitute "stock" for tax purposes, the repayment of such debt when it becomes due constitutes the redemption of "stock" for tax purposes. The result in many cases will be that the full amount of the debt repayment will be deemed a dividend, taxable in full as ordinary income. *R. M. Gunn*, 25 T.C. 424 (1955), *aff'd*, 44 F.2d 408 (10th Cir. 1957).

If the drastic penalty that will result from this case is to be imposed on a large number of taxpayers as a result of new judicial interpretation, when taxpayers have relied on a contrary interpretation over a long period of years, then such penalty should be imposed only by this Court after careful consideration.

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30. See, *e.g.*, *Rowan* v. *United States*, 219 F.2d 51, 54 (5th Cir. 1955).

31. See note 2, *supra*. Opinion denying rehearing, Appendix A, *infra*, p. A25, and Opinion, Appendix A, *infra*, pp. A2 and A5-A6.

6. The decision below is based upon a determination with respect to the rights of holders of the debentures which is in conflict with, and which fails to follow, a recent decision of the Georgia Court of Appeals. Here the court below agreed with the Government that because of the subordination to general creditors holders of the debentures are "practically helpless"[32] if the Company should choose to default in its obligations on the debentures, for whatever reason. This argument is based on the premise that holders of the subordinated debentures could not take legal action to enforce the obligations of the Company on the debentures so long as there were obligations to other creditors that were due and unpaid. Such premise is not valid. This is clearly shown by *Commercial Mortgage & Finance Corp.* v. *North American Investors, Inc.*, 111 Ga. App. 355, 141 S.E.2d 768 (1965). There a suit was brought by the holder of a promissory note which was subject to a subordination agreement, providing, among other things, that the right of the payee to demand or receive payment was subordinated to the claims of "all present and future creditors" of the maker. The Georgia Court of Appeals held that such subordination provision did not preclude a suit on the note, without regard to whether there were any outstanding claims of other creditors. This holding is in accord with general law. Subordination provisions, as expressly stated in the debentures here, are solely for the purpose of defining the relative rights of the holders of superior and subordinated indebtedness, and the debtor cannot assert such provision as a defense to a suit on subordinated indebtedness. Upon default of subordinated indebtedness, the holder can file suit against the debtor, obtain a judgment, and proceed to levy on the property of the debtor or take other appropriate legal ac-

32. Opinion, Exhibit A, *infra*, p. A10.

tion to collect the judgment. Holders of superior indebtedness under such circumstances can take appropriate action to enforce the subordination provisions in their favor. They can proceed in a court of equity or in a bankruptcy court to set up an equitable lien or constructive trust on any payment that would be recovered by the holder of the subordinated indebtedness on his judgment, to the extent necessary to satisfy the superior indebtedness. This remedy does not affect the amount to be paid by the debtor, but simply means that amounts recovered from the debtor go first to the holders of superior indebtedness. Once their claims are satisfied in full, the remaining property of the debtor becomes available for payment to the holders of subordinated indebtedness. If a holder of superior indebtedness chooses not to enforce his rights, this does not prevent the holders of subordinated indebtedness from enforcing their rights, but would merely be a waiver by the superior indebtedness of its right to prior payment.[33]

In spite of the invalidity of the premise upon which the argument of the Government is based, the majority opinion in the instant case accepts this argument, without citing any authority whatsoever and without making any reference to the decision of the Georgia Court of Appeals discussed above. The error of the majority below in this respect is emphatically pointed out by Judge Gewin in his dissent, where he says:

> "The majority is simply in error when it agreed with the Government that the debenture holders 'are practically helpless' if the taxpayer refuses to pay principal or interest when due, 'for any reason.' The

33. *Byrd & Sons Sales Corp.* v. *Tobin*, 78 F.2d 371, 100 A.L.R. 654 (8th Cir. 1935); *In re Dodge-Freedman Poultry Co.*, 148 F. Supp. 647 (D.N.H. 1956), *aff'd per curiam sub nom. Dodge-Freedman Poultry Co.* v. *Delaware Mills, Inc.*, 244 F.2d 314 (1st Cir. 1957); see Everett, *Subordinated Debt—Nature and Enforcement*, 20 Bus. Law. 953, 958 (1965).

law of Georgia is clearly to the contrary. A recent Georgia case so holds."[34]

Failure of the court below to follow the decision of the Georgia Court of Appeals in the *Commercial* case, and to follow general law, will have far-reaching effects. The form of the debentures used by Snyder Brothers Company, which is reproduced as an appendix to the opinion below, is in common use.[35] The decision of the court below casts serious doubt on the rights of holders of subordinated indebtedness to enforce such indebtedness, whereas such rights were heretofore well-established. This Court should grant certiorari to eliminate this doubt, and to correct the failure of the court below to recognize and follow Georgia law as established by its courts.

7. Regardless of whether the decision reached by the Fifth Circuit majority was or was not correct, it is one which cries out for review by this Court. Not only did the lower court discard the only Supreme Court decision on what may be the single most litigated point of federal tax law, but its decision conflicts with and calls into serious question an accepted line of appellate and Tax Court authority, recently acquiesced in by the Commissioner, and even casts doubt upon the enforceability of subordinated indebtedness contrary to all previous decisions on that question. The practical import of this decision cannot be overstated. It seems certain to have a devastating impact upon the use of subordinated debt in small corporations and may even curtail its use altogether. Perhaps, as a matter of tax policy, the use of subordination should be subjected to new and detailed scrutiny, but taxpayer submits that it is a far too important

34. Opinion, Exhibit A, *infra*, p. A21.

35. It is substantially identical to the typical debenture quoted in Everett, *Subordinated Debt—Nature and Enforcement*, note 33, *supra* at 956-59.

and well-accepted business practice to be overthrown by the decision of one circuit judge and one district judge, which is contrary to the dissent of one circuit judge and the directed verdict by one district judge.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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